# Federal Income Tax: Doctrine, Structure, and Policy
## Fourth Edition

## 2018 Cumulative Update For Students and Teachers

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The Fourth Edition was current when it went to press. This cumulative update includes important subsequent developments, the principal ones being the American Taxpayer Relief Act of 2012 (2012 ATRA), the Tax Increase Prevention Act of 2014 (TIPA), the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, the Protecting Americans from Tax Hikes Act of 2015 (the PATH Act), the 2017 Tax Cuts and Jobs Act (TCJA), and the 2018 Bipartisan Budget Act. This is a cumulative supplement; material not covered in earlier supplements appears in bold type.

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## Chapter 1

## TAXONOMY, HISTORY, AND THE INSTITUTIONAL STRUCTURE OF TAXATION IN THE UNITED STATES

### Page 5

Recent studies have concluded that the Constitution generally permits Congress to enact retroactive tax legislation as long as the period of retroactivity is not excessive. The Supreme Court has upheld tax laws whose retroactive effect extended into the preceding tax year but has given no clear guidance regarding the constitutional limit on retroactivity. *See* James M. Puckett, *Embracing the Queen of Hearts: Deference to Retroactive Tax Rules*, 40 FLA. STATE L. REV. 349 (2013); ERIKA K. LUNDER, ROBERT MELTZ & KENNETH R. THOMAS, CONSTITUTIONALITY OF RETROACTIVE TAX LEGISLATION (Cong. Res. Serv. Oct. 25, 2012), *available at* assets.opencrs.com/rpts/R42791_20121025.pdf.

### Page 10

Section 6702 allows the IRS to impose a $5,000 penalty on a taxpayer who files a return based on a "frivolous" legal argument and IRC § 6673(a) allows the Tax Court to impose a penalty of up to $25,000 on a taxpayer who brings an action in that court that is based on a "frivolous or groundless" legal position.

### Page 14

At the end of second paragraph under “1. National Taxing Jurisdiction over Income”: (However, the 2017 TCJA subjects active business income earned by U.S. corporations through certain foreign subsidiaries to a 10.5% minimum tax instead of the regular U.S. corporate tax.)

### Page 23

Regarding the authoritative status of the Blue Book, see Cole Barnett, *United States v. Woods and the Future of the Tax Blue Book as a Means of Penalty Avoidance and Statutory Interpretation*, 66 FLA. L. REV. 1791 (2014).

### Page 28

In *U.S.* v. *Home Concrete & Supply, LLC,* 132 S. Ct. 1836 (2012), the Supreme Court elaborated on the *Chevron, Brand X,* and *Mayo* line of cases. In *National Cable & Telecommunications Ass'n v. Brand X Internet Services*, 545 U.S. 967 (2005) (discussed in Chapter 15 and generally known as *Brand X),* the Supreme Court extended *Chevron* by holding that a judicial interpretation of an ambiguous federal statute can be reversed by a subsequent administrative regulation that satisfies the two-part *Chevron* test. According to *Brand X*, this administrative reversal power can always be exercised, unless the earlier court decision had held that the statutory provision in question was unambiguous so that the interpretation adopted in the earlier decision was the only permissible construction, thus leaving no room for the administrative agency to adopt a different interpretation.

Eight of the Justices in *Home Concrete* held that *Brand X* continues to be a valid gloss on the *Chevron* jurisprudence. However, pre-*Brand X* judicial opinions were written in ignorance of the ambiguous vs. unambiguous dichotomy that was made controlling by *Brand X*. Therefore, courts dealing with regulations purporting to reverse pre-*Brand X* opinions will have to carefully parse the judicial language to determine whether the opinion in question held that the subject statute fell on the ambiguous or unambiguous side of the line.

Neither *Chevron* nor *Brand X* involved a regulation that was issued in the midst of litigation for the purpose of affecting the outcome of that litigation. *Home Concrete* presented the opportunity to decide whether such a regulation qualifies for judicial deference under *Chevron* and *Brand X*, but the Court chose not to address this issue and so it remains an unresolved question. *See generally* Leandra Lederman, *The Fight Over "Fighting Regs" and Deference in Tax Litigation*, 92 B.U. L. REV. 643 (2012).

Recent judicial developments have chipped away at the deference accorded to regulations by *Chevron*. The quotation from *Mead* on page 27 of the casebook is popularly referred to as "*Chevron* step zero." It asks whether Congress has delegated authority to an agency to cure statutory ambiguity or fill statutory gaps and whether the regulation in question was promulgated pursuant to that authority. IRC § 7805(a) is usually regarded as providing the necessary congressional delegation of authority to promulgate income tax regulations and the act of expressly relying on that provision to promulgate a regulation is usually taken as conclusive evidence that the regulation was issued pursuant to delegated authority. Thus, income tax regulations are ordinarily considered to automatically satisfy *Chevron* step zero. This status quo was disturbed by the Supreme Court's opinion in *King v. Burwell*, 135 S. Ct. 475 (2015.)

That case involved the interpretation of an important ambiguous phrase ("Exchange established by the state") in the Affordable Care Act (Obamacare). This phrase controlled the availability of income tax credits for insurance premiums. Although the Act did not expressly give the IRS authority to interpret the phrase in question, such a regulation was promulgated under the authority of IRC § 7805(a). Nevertheless, the Supreme Court effectively held that even though the phrase in question was ambiguous, the regulation was not entitled to *Chevron* deference because it did not satisfy *Chevron* step zero. The Court gave the following explanation:

> Whether those credits are available on Federal Exchanges is thus a question of deep "economic and political significance" that is central to this statutory scheme; had Congress wished to assign that question to an agency, it surely would have done so expressly …. It is especially unlikely that Congress would have delegated this decision to the *IRS*, which has no expertise in crafting health insurance policy of this sort …. This is not a case for the *IRS*.

This quotation seems to create considerable leeway for courts to substitute their judgment for positions taken in income tax regulations when the courts feel that an issue of sufficient importance is involved. *King v. Burwell*, however, ultimately upheld the regulation involved in that case but did so on the basis of the Court's independent judgment instead of giving *Chevron* deference to the regulation.

In *Altera Corp. v. Comm'r*, 145 TC 91 (2015), the Tax Court held that *Chevron* step two (whether the agency's interpretation is "based on a reasonable construction of the statute") implicitly incorporates a requirement that a regulation must be the product of the agency's "reasoned decision-making," which means that "the agency must examine the relevant data and articulate a satisfactory explanation for its action including a rational connection between the facts found and the choice made." **If this** becomes the prevailing judicial view, Treasury will have to make a persuasive showing that the interpretation asserted in a particular regulation was arrived at through an informed and thoughtful process in addition to being a reasonable position.

**Page 30**

*Sunoco, Inc. v. U.S.*, 2016-2 USTC (CCH) ¶ 70, 341 (Fed. Cl. 2016) held that an IRS Notice issued during the pendency of litigation for the purpose of affecting that litigation, that cited no authority, and that was inconsistent with prior IRS pronouncements was not entitled to *Skidmore* deference.

**Page 32**

In *Kuretski v. Comm'r*, 2014-1 USTC CCH ¶ 50,329 (D.C. Cir. 2014), the D.C. Circuit held that the Tax Court is part of the executive branch of the federal government, so that the President's power under IRC § 7443(f) to remove Tax Court judges for good cause does not violate the separation of powers principle of the U.S. Constitution. The Supreme Court has denied certiorari. The PATH Act added the following to IRC § 7441: "The Tax Court is not an agency of, and shall be independent of, the executive branch of the Government." The impact of this language on the separation of powers issue that was adjudicated in *Kuretski* is presently unknown. Neither *Kuretski* nor the PATH Act amendment to IRC § 7441 appear to affect the Supreme Court's decision in *Freytag v. Comm'r*, 501 U.S. 868 (1991). That opinion held that the Tax Court is a "Court of Law" within the meaning of the Constitution's Appointments Clause (U.S. Constitution, Article II, section 2, clause 2) and exercises judicial power even though the Supreme Court also held that the Tax Court is established under Article I of the Constitution rather than Article III. *Byers v. U.S. Tax Court*, 2016-2 USTC (CCH) ¶ 50,431 (D. D.C. 2016), held that the U.S. Tax Court was a court, not an agency, for purposes of the Freedom of Information Act and was, therefore, exempt from the provisions of that Act.

## Chapter 2

## Basic Income Tax Principles

### Page 37

In *Shankar v. Comm'r*, 143 TC 140 (2014), Citibank had credited the taxpayer with 50,000 "Thank you Points" for opening a Citibank account. The taxpayer requested that these points be used to acquire an airline ticket. Citibank purchased the ticket, delivered it to the taxpayer, and issued a Form 1099 showing that the taxpayer had received income equal to the ticket's $668 purchase price. The Tax Court held that this amount was includable in the taxpayer's gross income. Some bank credit cards offer rewards (in cash or in kind) not tied to the bank's services (hence, not a price discount). Can these be distinguished from *Shankar*?

### Page 40

In Notice 2014-21, 2014-16 I.R.B. 938, the IRS held (i) that virtual currency such as Bitcoin is property rather than currency for federal tax purposes, (ii) that a taxpayer who receives virtual currency in exchange for services or property must treat the then fair market value of the virtual currency as an income inclusion or an amount realized, (iii) that such a taxpayer takes a basis in the virtual currency equal to its fair market value at the time of receipt, and (iv) that a taxpayer who pays for goods or services with virtual currency must recognize gain or loss equal to the difference between the currency's then fair market value and the taxpayer's basis. The gain or loss will be capital gain or loss if the virtual currency qualifies as a capital asset in the taxpayer's hands under IRC § 1221.

### Page 50

See entry for Page 32.

The 2017 TCJA essentially retains present-law maximum rates on net capital gains and qualified dividends. However, a three-year holding period is now required to achieve long-term capital gains treatment with respect to sales of certain partnership interests. See Chapter 25, this update.

### Page 52

2012 ATRA continues the generally applicable long-term capital gains rate at 15 percent. However, for "high income taxpayers" (which, generally speaking, means individuals in the 35% or 37% marginal rate bracket) the generally applicable long-term capital gains rate is now 20 percent.

### Page 57

Jean's deduction for office supplies is allowed by recently promulgated Regs. §§ 1.162-3(a)(2), 1.263(a)-2(c)(2). Reg. § 1.162-3(h) Example 9 assumes that the property therein was not incidental supplies. *See* Reg. § 1.162-3(h) (first paragraph). We assume that Jean's supplies are copier paper, legal pads, pens, and pencils, etc. that qualify as incidental.

**Pages 58-59**

Under the 2017 TCJA in some cases, the cost of a business or investment asset can be fully deducted (expensed) at the time of acquisition instead of being recovered through depreciation deductions spread over future years. *See* Chapter 6, this update.

**Page 59**

To keep matters simple at this early stage, the discussion of Jean's depreciation deductions intentionally omits consideration of IRC §§ 168(k) and 179. Those provisions, which deviate from the general rules, will be covered in Chapters 6 and 28.

**Pages 63-67**

The 2017 TCJA has increased the standard deduction to $24,000 for joint filers, $18,000 for head of household filers, and $12,000 for all other individuals. These increased amounts are indexed for inflation. They are effective for tax years beginning after 2017 but do not apply to tax years beginning after 2025.

For tax years beginning after 2017 and before 2026, the 2017 TCJA suspends the deduction for personal exemptions, including personal exemptions for dependents.

With respect to tax years beginning after 2017 and before 2026, the 2017 TCJA suspends all miscellaneous itemized deductions that are subject to the IRC § 67 two percent floor, including unreimbursed employee business expenses and IRC § 212 deductions other than those covered by IRC § 62(a)(4) (related to rental and royalty income) and IRC § 62(a)(20) (related to certain litigation expenses). Thus, the two percent floor is irrelevant during the suspension period.

The 2017 TCJA includes a new IRC § 199A that allows a deduction for a portion of certain "pass-through income" realized by individuals, trusts, or estates. *See* Chapter 4, this update, for details. This deduction is not an itemized deduction allowable in arriving at adjusted gross income (*see* IRC § 63(d)(3)) and, therefore, is not affected by the suspension of miscellaneous itemized deductions. Moreover, it is allowed to non-itemizers, i.e. it can be claimed in addition to the standard deduction. *See* IRC § 63(b)(3).

For tax years beginning after 2017 and before 2026, the 2017 TCJA suspends the IRC § 68 overall limitation on itemized deductions, thus making this limitation irrelevant during the suspension period. Its suspension makes charitable contributions more attractive to high income taxpayers than before. Section 68 is popularly known as the "Pease limitation" because it was originally proposed by the late congressman Donald Pease of Ohio.

The above-the-line deduction allowed by IRC § 62(a)(2)(D) for small expenses incurred by K-12 teachers for work-related books, supplies, etc. was made permanent by the PATH Act.

**Page 68**

The 2017 TCJA completely repealed the corporate AMT and increased the individual AMT's exemption amount and phaseout thresholds and also indexed them for inflation. The Tax Policy Center has estimated that these changes will cause the individual AMT's coverage to drop from $5 million taxpayers to 200,000. The corporate AMT repeal is effective for tax years beginning after 2017. The individual AMT changes are effective only for tax years beginning after 2017 and before 2026.

## Chapter 4

## Rates and Allowances for Basic Maintenance

### Page 90

The 2017 TCJA imposes the following rates (indexed for inflation) on individuals, estates, and trusts for tax years beginning after 2017 and before 2026:

| If taxable income is: | Then income tax equals: |
|---|---|
| ***Single Individuals*** | |
| Not over $9, 525 | 10% of the taxable income |
| Over $9,525 but not over $38,700 | $952.50 plus 12% of the excess over $9,525 |
| Over $38,700 but not over $82,500 | $4,453.50 plus 22% of the excess over $38,700 |
| Over $82,500 but not over $157,500 | $14,089.50 plus 24% of the excess over $82,500 |
| Over $157,500 but not over $200,000 | $32,089.50 plus 32% of the excess over $157,500 |
| Over $200,000 but not over $500,000 | $45,689.50 plus 35% of the excess over $200,000 |
| Over $500,000 | $150,689.50 plus 37% of the excess over $500,000 |
| ***Heads of Households*** | |
| Not over $13,600 | 10% of the taxable income |
| Over $13,600 but not over $51,800 | $1,360 plus 12% of the excess over $13,600 |
| Over $51,800 but not over $82,500 | $5,944 plus 22% of the excess over $51,800 |
| Over $82,500 but not over $157,500 | $12,698 plus 24% of the excess over $82,500 |
| Over $157,500 but not over $200,000 | $30, 698 plus 32% of the excess over $157,500 |
| Over $200,000 but not over $500,000 | $44,298 plus 35% of the excess over $200,000 |
| Over $500,000 | $149,298 plus 37% of the excess over $500,000 |
| ***Married Individuals Filing Joint Returns and Surviving Spouses*** | |
| Not over $19,050 | 10% of the taxable income |
| Over $19,050 but not over $77,400 | $1,905 plus 12% of the excess over $19,050 |
| Over $77,400 but not over $165,000 | $8,907 plus 22% of the excess over $77,400 |
| Over $165,000 but not over $315,000 | $28,179 plus 24% of the excess over $165,000 |
| Over $315,000 but not over $400,000 | $64,179 plus 32% of the excess over $315,000 |
| Over $400,000 but not over $600,000 | $91,379 plus 35% of the excess over $400,000 |
| Over $600,000 | $161,379 plus 37% of the excess over $600,000 |

***Married Individuals Filing Separate Returns***

| | |
|---|---|
| Not over $9,525 | 10% of the taxable income |
| Over $9,525 but not over $38,700 | $952.50 plus 12% of the excess over $9,525 |
| Over $38,700 but not over $82,500 | $4,453.50 plus 22% of the excess over $38,700 |
| Over $82,500 but not over $157,500 | $14,089.50 plus 24% of the excess over $82,500 |
| Over $157,500 but not over $200,000 | $32,089.50 plus 32% of the excess over $157,500 |
| Over $200,000 but not over $300,000 | $45,689.50 plus 35% of the excess over $200,000 |
| Over $300,000 | $80,689.50 plus 37% of the excess over $300,000 |

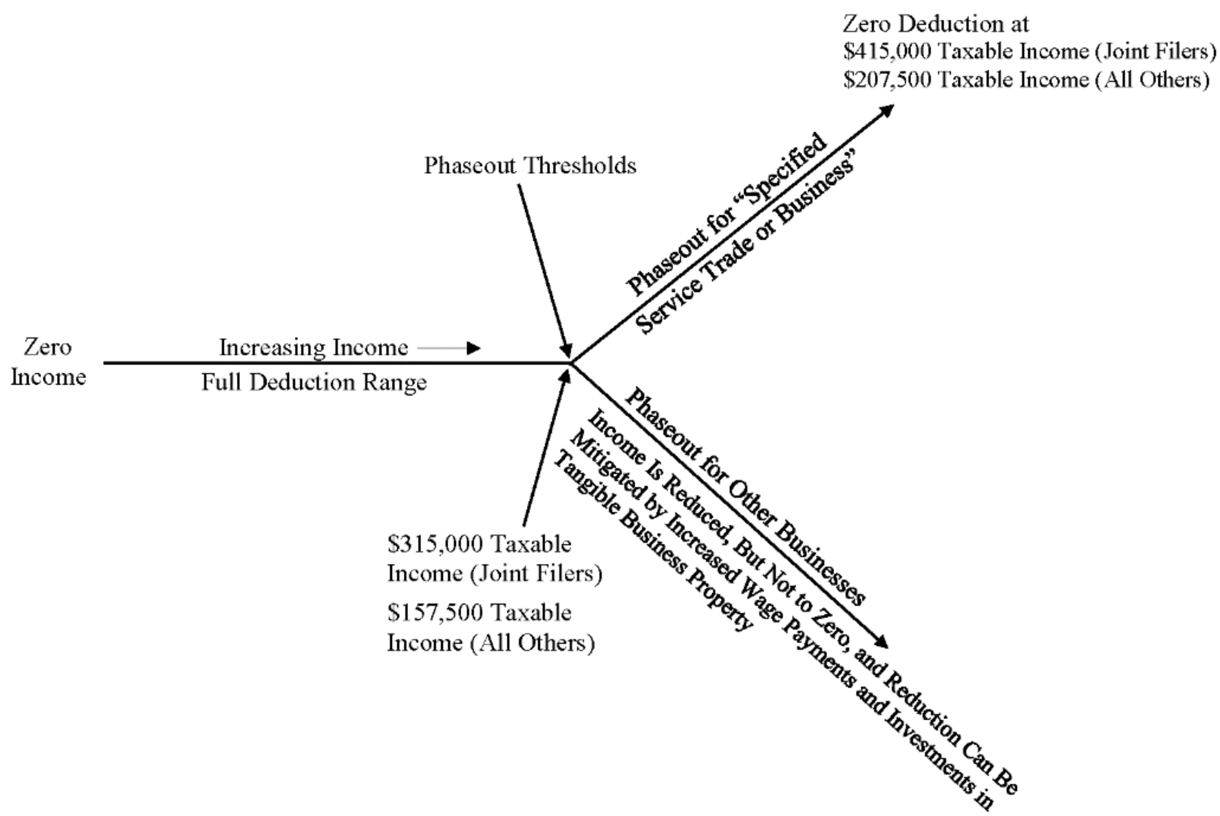
***Estates and Trusts***

| | |
|---|---|
| Not over $2,550 | 10% of the taxable income |
| Over $2,550 but not over $9,150 | $255 plus 24% of the excess over $19,050 |
| Over $9,150 but not over $12,500 | $1,839 plus 35% of the excess over $9,150 |
| Over $12,500 | $3,011.50 plus 37% of the excess over $12,500 |

The 2017 TCJA permanently replaces the IRC § 11 graduated corporate rate with a flat 21% rate. This change is effective for tax years beginning after 2017.

The 2017 TCJA includes a new IRC § 199A. This is an extremely complex provision the details of which are properly reserved for an advanced course. For purposes of the basic income tax course, it is sufficient to note that although IRC § 199A has restrictions and limitations that can impose constraints on its benefit, when those restrictions and limitations are avoided, this new provision allows non-corporate taxpayers to deduct 20% of the business income of "pass-throughs"—i.e. S corporations, organizations treated as partnerships, and sole proprietorships (including the business of being an independent contractor but not the business of being an employee). This deduction is not an itemized deduction allowable in arriving at adjusted gross income and, therefore, is not affected by the suspension of miscellaneous itemized deductions. Moreover, it can be claimed in addition to the standard deduction.

**The following schematic presents the big picture of IRC § 199A:**




This provision is effective for tax years beginning after 2017 and before 2026. The 20% deduction does not represent a cost of producing income. Instead, it is merely a device to reduce the rate on eligible business income. For example, if an individual sole proprietor's marginal rate is 37%, the deduction will effectively decrease that rate to 29.6% (37% x [1-.20]). The policy significance of IRC § 199A is that it adds to a disparate array of rates applicable to ordinary business income. To be specific:

- Income earned as employee can be taxed at up to 37%.
- Business income earned as an independent contractor, sole proprietor, or through an S corporation or an entity treated as a partnership generally will not be taxed in excess of 29.6% when IRC § 199A is applicable.
- Business income earned through a C corporation will be taxed on the corporate level at 21%. In addition, when C corporation income is distributed as dividends, it bears a second tax at a maximum rate of 23.8% if the recipient shareholder is a taxable individual. But the tax rate on dividends is 0% where the shareholder is one of the many tax-exempt organizations that own corporate stock.

**Page 92**

In *U.S. v. Windsor*, 133 S. Ct. 2675 (2013), the Supreme Court declared Defense of Marriage Act § 3 unconstitutional. The IRS responded by issuing Rev. Rul. 2013-17, 2013-2 C.B. 201, to conform the Internal Revenue Code to *Windsor*. Then in *Obergefell v. Hodges*, 135 S. Ct. 2071(2015), the Supreme Court held that state laws reserving marriage to heterosexual couples are "invalid to the extent they exclude same-sex couples from civil marriage on the same terms and conditions as opposite-sex couples," and also held that "there is no lawful basis for a State to refuse to recognize a lawful same-sex marriage performed in another State on the ground of its same-sex character." Treasury has now promulgated Reg. § 301.7701-18 to reflect these developments and to supersede Rev. Rul. 2013-17. The new Regulation effectively allows same-sex couples who are considered married under the law of the state where their ceremony occurred to file joint federal income tax returns. If they choose not to file jointly, they must use the IRC § 1(d) rate table for marrieds filing separately, rather than the IRC § 1(c) rate table for unmarried individuals. In contrast, individuals are not considered married for federal income tax purposes if they "have entered into a registered domestic partnership, civil union, or other similar formal relationship not denominated as a marriage under the law of" the U.S. jurisdiction where the relationship was entered into. The new Regulation does not affect Rev. Rul. 58-66, which holds that a couple will be treated as husband and wife for federal income tax purposes if they have entered into a common law marriage in a state that recognized their relationship as a valid marriage even if they are now living in a state that does not recognize their common law marriage. **Recent research determined that about 0.48 percent of all 2015 joint filers (about 250,450 couples) were same-sex couples. *See* Tax Policy Center, Same-Sex Married Tax Filers After Windsor and Obergefell (2018).**

**Page 95**

2012 ATRA granted marriage penalty relief by permanently providing that the 15% bracket for joint filers and surviving spouses is twice the size of the 15% bracket for singles.

**Page 98**

2012 ATRA granted additional marriage penalty relief by permanently providing that the standard deduction for joint filers and surviving spouses is twice the size of the inflation-adjusted standard deduction for singles and marrieds filing separately.
2012 ATRA restored the personal exemption phase-out (popularly known as the PEP and referred to on page 103). This phase-out reduces each individual taxpayer's total amount of personal exemption deductions by 2% for each $2,500, or fraction thereof, of the taxpayer's adjusted gross income in excess of the taxpayer's "applicable amount." However, if the taxpayer is married filing separately, the preceding $2,500 amount is reduced to $1,250. The applicable amounts, to be inflation adjusted after 2013, are:

$300,000 for joint filers and surviving spouses

$275,000 for heads of households

$250,000 for singles

$150,000 for marrieds filing separately.

**Pages 98-104**

The 2017 TCJA substantially enlarges the standard deduction and suspends the personal and dependency exemptions deductions. The suspension is temporary. *See* Chapter 2, this update.

**Page 104**

The 2017 TCJA increases the IRC § 24 child tax credit to $2,000 per qualifying child and provides a $500 nonrefundable credit for qualifying dependents other than qualifying children. The phaseout threshold is raised to $400,000 for all joint filers and $200,000 for other taxpayers. These changes are effective for tax years beginning after 2017 and before 2026.

**Page 105**

Errata: The adoption credit is governed by IRC § 23 and excess credits are non-refundable but benefit from a 5-year carryforward.

## Chapter 5

## Deductions for Off-The-Bottom Personal Expenses

### Pages 110-16

The 2017 TCJA repeals the IRC §§ 61(a)(8) and 71 inclusions of alimony payments in the payee spouse's income, repeals the payor's IRC § 215 deduction, and repeals the IRC § 682 alimony trust provision. The treatment of child support payments is not changed. Thus, *Gould v. Gould*, *see* Casebook p. 37, now governs both alimony and child support payments. There is no deduction for either by the payor and no inclusion for either by the payee. In addition, the tax treatment of the income of alimony trusts is now returned to the uncertain state described at Casebook p. 113. These changes are effective with respect to divorce or separation instruments executed after 2018. IRC § 1041 was not affected by the 2017 TCJA.

### Page 112

In *Peery v. Comm'r*, T.C. Memo. 2014-151, the Tax Court held that because a separation agreement characterized a particular cash payment as a "property settlement," the payment was automatically considered to be designated by the parties as not includable in gross income and not deductible under IRC § 215. Therefore, IRC § 71 (b)(1)(B) was not satisfied and the payment did not qualify as alimony or separate maintenance for purposes of IRC §§ 71(a) and 215(a).

### Pages 116-17

The 2017 TCJA modifies the extent to which taxes are deductible by individuals under IRC § 164. It provides that individuals may deduct all state, local, and foreign taxes that are connected with carrying on a business or investment activity. Moreover, state, local, and foreign income taxes are deductible by individuals regardless of whether there is a connection to a business or investment activity. However, (1) all state and local income taxes paid or accrued in a given year by an individual (even if there is a business or investment connection) and (2) all other state and local taxes paid or accrued by an individual in a given year that lack a business or investment connection are only deductible to the extent that the aggregate of such taxes does not exceed $10,000 ($5,000 in the case of married taxpayers filing separately). In applying the $10,000/$5,000 cap, individuals continue to have an election to substitute state and local general sales taxes for state and local income taxes. In addition, this $10,000/$5,000 cap does not apply to corporations, and foreign real property taxes that lack a business or investment connection are nondeductible by individuals even if they fit within the $10,000/$5,000 cap. There is no change to the IRC § 275(a)(4) prohibition against deducting foreign taxes claimed as credits under IRC § 901.

The 2017 TCJA's changes to the deductibility of taxes are effective for tax years beginning after 2017 and before 2026. This caused residents of states with high real property taxes to seek to avoid the 10% cap by making December 2017 payments of 2018 state and local taxes on personal use real property. On December 27, 2017, the IRS issued an Advisory stating that these prepayments would be deductible only to the extent that the 2018 taxes had been formally assessed in 2017.

**Page 119**

**The 2017 TCJA's restriction on the deduction for state and local taxes has produced state-level action or proposals to circumvent the restriction by giving state income tax credits for contributions made to states or state instrumentalities. The hope is that the contributions will be fully deductible under IRC § 170(a). In response, the IRS has promulgated Prop. Reg. 1.170A-1(h)(3). It provides that (i) if a taxpayer contributes to an IRC § 170(c) entity in consideration for receiving a state or local tax credit, the taxpayer's IRC § 170(a) deduction will be reduced by the amount of the credit, (ii) there will be no diminution in the IRC § 170(c) deduction if the state or local tax benefit is a deduction rather than a credit and the deduction does not exceed the contribution amount, and (iii) there will be no reduction in the IRC § 170 deduction if the state or local tax credit does not exceed 15% of the taxpayer's contribution.**

**Pages 124-128**

The 2017 TCJA suspended all miscellaneous itemized deductions that are subject to the IRC § 67 two percent floor. See Chapter 2, this update. This suspension includes IRC § 212(3).

**Page 128**

The 2017 TCJA provides that the 10% of AGI threshold for the medical expense deduction in IRC § 213 drops back to 7.5%. This change is generally effective for tax years beginning after 2016 and ending before 2019.

## Chapter 6

## Viewing the Income Tax Through a Consumption Tax Lens

### Page 157

The 2017 TCJA increases the maximum IRC § 179 expense deduction to $1 million per year and increases the phaseout threshold to $2,500,000. These amounts are indexed for inflation with regard to tax years beginning after 2018. Property that qualifies for IRC § 179 expensing is expanded to include the following improvements to nonresidential rental property: roofs, heating, ventilation and air conditioning property, fire protection and alarm systems, and security systems.

IRC § 168(k) allows so called “bonus depreciation” with respect to certain property including, but not limited to, IRC § 179 property. The IRC § 168(k) deduction is set as a percentage of the basis remaining in eligible property after reduction for any IRC § 179 deduction. *See* Reg. §1.168 (k)-1(a) (2) (iii). Thus, IRC § 168(k) is irrelevant with respect to property that can be expensed under IRC § 179. However, IRC § 168(k) applies to certain property that falls outside the scope of IRC § 179. The 2017 TCJA amends IRC § 168(k) to provide that for eligible property placed in service after September 27, 2017 and before 2023, 100% of its adjusted basis may be deducted (expensed) in the service commencement year. For property placed in service in 2023, the deductible amount is generally only 80% of adjusted basis and the deduction percentage generally declines by 20 percentage points each year after 2023 so that nothing is deductible under IRC § 168(k) with respect to eligible property placed in service after 2026. Deductions under amended IRC § 168(k) are available for both new and used property, apparently including used property that is sold by the owner to an unrelated party who claims deductions under IRC § 168(k) and leases the property back to the original owner. The definition of qualified property is expanded to include film, television, and live theatrical productions placed in service after September 27, 2017, and before 2027 if at least 75% of the total compensation expended on the production is for work done in the United States. Qualified property generally excludes assets used by regulated public utilities. Qualified property includes debt-financed property. Thus, IRC § 168(k) allows expensing of assets (including used property) with respect to which interest deductions on acquisition debt are allowable. This can result in negative effective tax rates. *See* Chapter 18, this update regarding an overall limitation on the deduction of interest expense. IRC § 168(k) deductions are taken before regular IRC § 168(a) depreciation deductions.

## Chapter 7

## The Capitalization Principle in Practice

### Page 170

Note 2 refers to a *de minimis* rule in Reg. § 1.162-6. Effective January 1, 2014, that Regulation is repealed and replaced by a more complex *de minimis* rule that requires the taxpayer to have a professionally prepared financial statement of the type used for government reporting or financial transaction purposes. The new rule requires the taxpayer to show the costs in question on the financial statement as expenses and requires that the total aggregate amounts be quite small. *See* Reg. §§ l.162-3(f), l.162-3(h), Example 14, 1.263(a)- 1(f)(1), 1.263- 1(f)(7) Examples 4, 6. These changes will make the *de minimis* rule unavailable to most taxpayers.

### Page 173

The 2017 TCJA exempts from IRC § 263A any taxpayer (other than a tax shelter) that has annual average gross receipts of $25 million or less for the three preceding taxable years. Starting with tax years beginning after 2018, this $25 million amount is adjusted annually for inflation.

### Page 174

As explained above, Reg. § 1.162-6 is repealed effective January I, 2014. Its replacement is too complex to warrant coverage in the basic tax course. Therefore, Problem 2.(b) can be omitted.

### Page 177

In Problem 1, Reg. § 1.263(a)-2(e) is repealed and replaced by Reg. §§ 1.263(a)-1(d), (e), 1.263(a)-2(f)(3), and 1.263(a)-2(f)(4), Example 1, effective January 1, 2014.

### Pages 184-87

Delete everything from the beginning of page 184 up to the Problems on page 187 and insert the following:

> Effective January 1, 2014, the material on pages 184-187 up to the Problems was superseded by new Reg. § 1.263(a)-3. This new Regulation provides that an expenditure qualifies as a deductible repair expense if it is incurred with respect to a unit of business or investment property and if
>
> (1) The expenditure is *not* for a betterment to the unit of property,
>
> (2) The expenditure does *not* restore the unit of property, and
>
> (3) The expenditure does *not* adapt the unit of property to a new or different use.

An expenditure that effects either a betterment, restoration, or adaptation is, generally speaking, not a deductible repair expenditure unless it is covered by the *de minimis* exception that is limited to $5,000 in some cases and $2,500 in others (Reg. § 1.263(a)-1(f); Notice 2015-82, 2015-50 I.R.B. 133) or is covered by the small taxpayer exception (Reg. § 1.263(a)-3(h)), or the routine maintenance exception (Reg. § 1.263(a)-3(i)).

The new Regulation provides highly detailed rules for determining what constitutes a unit of property and for defining "betterment," "restore," and "adapt to a new or different use." Although these rules generally follow the superseded material in the casebook, they make some changes. More importantly, they are much more complex and lengthy than the old rules and they include 116 dense examples that are essential to understanding the new regime. Intensive consideration of such specialized and intricate material must be reserved for an advanced course; far too much time would be required than can be justified in the basic income tax course. The best approach for the basic course is to give students an experience that provides a sense of the new Regulation's underlying principles and of the process for getting answers from complex material. We recommend going directly from Casebook page 183 to the Problems on Casebook page 187 and working those Problems by referring to the Regulations cited below and by assuming that neither the *de minimis* exception, the small taxpayer exception, nor the routine maintenance exception applies.

Problem 1, *see* Reg. § 1.263(a)-3(d) ("generally must capitalize")

Problem 2(a), *see* Reg. § 1.263(a)-3(j)(3), Example 13; Reg. § 1.263(a)-3(k)(7), Examples 14 and 15; Reg. § 1.263(a)-3(l)(1), (2).

Problems 2(b), (c), *see* Reg. § 1.263(a)-3(j)(3), Examples 1 and 2, and Regulations cited with respect to Problem 2(a).

Problem 2(d), *see* Reg. § 1.263(a)-2(d)(1); Reg. § 1.263(a)-3(j)(1)(ii); Reg. § 1.263(a)-(3)(j)(3), Example 7.

Problem 2(e), *see* Reg. § 1.263(a)-3(j)(3) Examples 6, 8; Reg. § 1.263(a)-3(k)(7), Examples 24, 28, 29.

Problem 2(f), *see* Reg. § 1.263(a)-3(k)(1); Reg. § 1.263(a)-3(k)(7), Example 3.

For more details, *see* Carol Conjura, Catherine A. Fitzpatrick, Keith Jordan & Karen Messner, *Repairs vs. Capital Improvements: Do the Final Regulations at Last Clarify the Distinction?*, 119 J. TAX'N 204 (Nov. 2013); W. Eugene Seago, *"Improvements" Under the Repair Regulations*, 142 TAX NOTES 639 (2014).

## Chapter 8

## The Basic Framework Governing Business and Investment Deductions

### Pages 191-97

The 2017 TCJA's suspension of all itemized deductions that were subject to the IRC § 67 two percent floor includes suspension of all parts of IRC § 212 with the exception of expenses covered by IRC §§ 62(a)(4), (20). Consequently, *Higgins* and other cases defining the difference between business and investment activity have heightened importance during the suspension period.

### Page 203

The 2017 TCJA generally repeals IRC § 199 for tax years beginning after 2017.

### Page 207

With respect to Note 2(b), recently issued Regulations, effective January 1, 2014, provide that expenses incurred by a real property owner to resist a local government's exercise of eminent domain with respect to the property and a local government's establishment of a building line on the property were amounts paid to defend title to property and had to be capitalized. *See* Reg. § 1.263(a)-2(e)(2), Examples 1 and 3.

### Page 209

The 2017 TCJA amends IRC § 162(f) to provide a blanket prohibition against deducting "any amount paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, a government or governmental entity in relation to the violation of any law or the investigation or inquiry by such government or entity into the potential violation of any law." This prohibition includes reimbursement payments to governments or governmental entities for investigation and litigation costs. For these purposes, non-governmental entities that exercise certain self-regulatory powers are treated as governmental entities. This deduction prohibition seems to apply regardless of whether the government or governmental entity is domestic or foreign and it extends IRC § 162(f) beyond fines or similar penalties paid for actual violations of law. It also makes IRC § 162(f) applicable to all income tax deduction provisions, not just § 162. Amended IRC § 162(f) has a number of exceptions, however:

- It does not generally apply to payments in the nature of restitution or remediation.
- It does not generally apply to payments made to come into compliance with relevant law.
- It does not apply to tax payments.
- It does not apply to payments made by reason of a court order in a suit to which no government or governmental entity was a party.

Amended IRC § 162(f) is effective with respect to amounts paid or incurred on or after December 22, 2017.

The 2017 TA amended IRC §162 by inserting a new subsection 162(q) which prohibits any deduction under any income tax provision for:

(1) Any settlement or payment related to sexual harassment or sexual abuse if such settlement or payment is subject to a nondisclosure agreement, or
(2) Attorneys' fees related to such settlement or payment.

Note that this language might be sufficiently broad to apply to a victim's attorneys' fees which would otherwise be deductible under IRC § 212. We await Regulations to see whether this broad interpretation will be applied. If it is, then the relationship between IRC § 62(a)(20) and IRC § 162(q) is important. Although IRC § 212 has been generally suspended, deductions thereunder are not affected by the suspension to the extent that the deductions are covered by IRC § 62(a)(20). IRC § 162(q) is, however, a new requirement that must be satisfied in order to deduct IRC § 62(a)(20) attorneys' fees under IRC § 212.

The 2017 TCJA eliminates the performance-based compensation exception from IRC § 162(m).

**Page 210**

The 2017 TCJA amends the IRC §162(e) disallowance of deductions for lobbying expenses to eliminate the exception for local lobbying costs.

## Chapter 9

## Defining the Personal Realm: Of Human Capital

### Pages 222-23

2012 ATRA permanently extended the IRC § 127 exclusion for certain employer provided education.

The PATH Act extended the IRC § 222 deduction for "qualified tuition and related expenses" to cover expenses paid before January 1, 2017. **Section 222 had not been extended beyond 2017 when this update was written.**

The HOPE credit's $2,500 limit, partial refundability, and four-year coverage were extended by 2012 ATRA to apply to tax years beginning before 2018. The HOPE credit has been re-named the American Opportunity Credit. The credit limit is now permanently $2,500 per student. Forty percent of this is refundable. The credit is now permanently available for four years of post-secondary, undergraduate education.

Contributions to IRC § 529 plans are not deductible for federal income tax purposes. The 2017 TCJA amends IRC § 529 to allow distributions of up to $10,000 per year, per student, to cover K-12 tuition expenses including tuition expenses at a religious school.

### Page 225

Except for certain moving expenses of certain Armed Forces members, the 2017 TCJA suspends the IRC § 217 moving expense deduction for taxable years beginning after 2017 and before 2026.

### Page 226

Except for certain Armed Forces members, the 2017 TCJA generally suspends the IRC § 132(g) exclusion for employer-provided moving expense reimbursements for tax years beginning after 2017 and before 2026.

## Chapter 10

## Dual Purpose Outlays

### Page 231

The IRC § 183(b)(2) deduction is a miscellaneous itemized deduction that is suspended by the 2017 TCJA with respect to tax years beginning after 2017 and before 2026. During this period, no IRC § 183(b)(2) deductions are allowable.

### Page 238

For tax years beginning after 2017 and before 2026, the 2017 TCJA amends IRC § 165(d) to provide that the phrase "losses from wagering transactions" includes any otherwise deductible expenses of carrying on a gambler's gambling activity.

### Page 239

In *Park v. Commissioner*, 722 F.3d 384 (D.C. Cir. 2013), the IRS argued that the approach taken in GLAM 2008-011 applied only to U.S. citizens and resident aliens. The District of Columbia Circuit rejected this approach, reversed the Tax Court, and held that the "gambling session" interpretation of "wagering transaction," adopted in GLAM 2008-011, also applied to nonresident aliens.

## Chapter 11

## Allocating Costs Between the Income Production and Personal Realms

### Page 250

The 2017 TCJA removes "computer or peripheral equipment" from inclusion in listed property.

### Page 256

With respect to tax years beginning after 2017 and before 2026, the 2017 TCJA suspends all miscellaneous itemized deductions that are subject to the IRC § 67 two percent floor, including unreimbursed employee business expenses. Thus, employees are effectively denied travel and entertainment expense deductions during the suspension period.

### Page 266

In *Liljeberg v. Comm'r*, 148 TC ___ No. 6 (2017), foreign students had worked in the United States at summer jobs under a U.S. State Department cultural exchange program and had then returned to their home countries as required by the program's terms. The parties agreed that the students' wages were includable in gross income and that their summer work constituted carrying on a trade or business. The students claimed IRC § 162 business expense deductions for their airfare, travel health insurance, and meals and entertainment. None of the students had continuing home country employment or business activities from which they were temporarily absent during their summer in the United States nor did any applicable provision of law require them to maintain an "abode" in their respective home countries while they were working in the United States. Therefore, the Tax Court disallowed the claimed deductions because they failed the "away from home" requirement of IRC § 162(a)(2) in spite of the temporary character of the students' U.S. employment. The Tax Court also held that even though the students' health insurance expenses were required by terms of the State Department program, they were personal expenses that only could be deducted subject to the 10 percent floor, as it then was, of IRC § 213.

### Pages 268-71

The 2017 TCJA prohibits deductions (1) for entertainment, amusement, and recreation activities, (2) for membership dues in any business, recreation, or social club, and (3) with respect to any facility or portion thereof used in connection with any entertainment, amusement, or recreation activity. This repeals the "directly related" and "associated with" entertainment expense deductions described on Casebook page 269. The 2017 TCJA continues to allow employers to deduct 50% of the cost of meals consumed by employees on business travel but disallows employer deductions for providing IRC § 132(f) qualified transportation fringes and generally disallows employer deductions for covering the commuting costs of employees. For amounts incurred and paid after 2017 and before 2026, the 2017 TCJA extends the IRC § 274(n) 50% disallowance rule to the employer's cost of operating employer-provided eating facilities that furnish meals excludable by the employee under IRC § 132(e)(2) and the cost of any meal or beverages (including under IRC § 132(e)(1)) associated with such facilities, as well as the cost of any meals furnished for the convenience of the employer on the employer's business premises and excludable by the employee under IRC § 119(a). After 2025, no employer deduction is allowed for these meal costs.

**Page 271**

In Rev. Proc. 2013-13, 2013-6 I.R.B. 478, the IRS promulgated a simplified optional method for calculating home office deductions that otherwise satisfy the requirements of IRC § 280A(c)(1). The optional deduction is $5 per square foot up to a maximum of 300 square feet.

Treasury has issued Final Regulations, effective for tax years beginning after August 1, 2013, dealing with reimbursed expenses covered by IRC § 274(e)(3). The Regulations generally track the book text and the Code language and contain no surprises.

## Chapter 12

## Forms of Compensation Income

### Page 282

**IRC § 132(d) provides that the value of property or services provided to an employee is a working condition fringe excludable under IRC § 132(a)(3) "to the extent that, if the employee paid for such property or services, such payment would be allowable as a deduction under section 162 or 167." If IRC § 132(d) means that we must hypothesize that the employee paid for the property or services in her or his capacity as an employee, then the employee's hypothetical cost would be an unreimbursed employee business expense. Before the TCJA, unreimbursed employee business expenses were MIDs deductible only to the extent allowable by the IRC § 67(a) two percent floor. However, Reg. § 1.132-5(a) provides that "[t]he limitation of section 67(a)…is not considered when determining the amount of a working condition fringe." The TCJA added IRC § 67(d) which provides that "[n]ot withstanding subsection (a), no miscellaneous itemized deduction shall be allowed for any taxable year beginning after December 31, 2017, and before January 1, 2026." At the time this update was written, no guidance had been issued to indicate whether (1) the above-quoted Regulation will be extended to make IRC § 67(d) inapplicable for purposes of the working condition fringe benefit exclusion or (2) the working condition fringe benefit provision will be unavailable during IRC § 67(d)'s effective period because employees will not be allowed deductions for their unreimbursed business costs. The latter alternative would impose enormous administrative and compliance burdens on the IRS and taxpayers. This can be avoided by hypothesizing that the employee paid for the property for services in the capacity of a non-employee.**

### Page 288

*Jacobs v. Comm'r*, 148 TC ___ No.24 (2017) involved the Boston Bruins National Hockey League team. The team's contracts with hotels where it stayed when travelling to away games required the hotels to provide pre-game meals in hotel space for all players and accompanying management and support personnel. Substantial pre-game preparation and other management activities occurred during the meals. The recipients got the meals for free. The team also used its contracted sleeping rooms and other hotel space for player rest, player strength and conditioning work, and treatment of player injuries. The Tax Court held that (i) the hotel meal rooms were eating facilities operated by the team for purposes of IRC § 132(e)(2), (ii) the contracted hotel space constituted business premises of the employer for purposes of IRC § 132(e)(2)(A) and IRC § 119(a)(1), and (iii) the meals were furnished for the convenience of the employer within the meaning of IRC § 119(a), so that the meal recipients were deemed by the last sentence of § 132(a)(2) to have paid the direct operating costs of the meals as required by IRC § 132(e)(2)(B). Therefore, the IRC § 274(n)(2)(B) exception to the IRC § 274(n)(1) 50 percent disallowance rule applied and the team's cost for the meals was fully deductible.

## Chapter 14

## Recoveries for Personal Injury Other Windfall Receipts

### Page 320

The PATH Act added new IRC § 139F to the Code. It provides a gross income exclusion for the entire amount of any wrongful conviction award to an individual who was wrongfully convicted under state or federal criminal law and who served at least part of the related sentence. *In re Elkins*, 2016 Bankr. LEXIS 2291 (2016), is a decision by the U.S. Bankruptcy Court for the Northern District of Ohio. It holds that IRC § 139F applies only to damages received by the wrongfully convicted individual and not to derivative awards made to family members of that individual.

### Pages 321-23

Treasury has promulgated new Regulations under IRC § 104(a)(2) that neither change nor add to the discussion in the book. See Reg. § 1.104-1. Disappointingly, the Regulations do not clarify the distinction between personal physical injuries and personal non-physical injuries.

In *Perez v. Comm'r*, 144 TC 51 (2015), the taxpayer "donated" her eggs to infertile couples and received $20,000 for doing so. The "donation" contracts stated that this was consideration for pain and suffering incident to the donation procedure and not for sale of the eggs. Taxpayer contended that the consideration was excludable under IRC § 104(a)(2). The Tax Court held that the consideration was not damages for a personal injury within the meaning of IRC § 104(a)(2) but was, instead, includable in gross income as compensation for services.

### Page 324

Although IRC § 212 has been generally suspended through 2025, deductions thereunder are not affected by the suspension to the extent that the deductions are covered by IRC § 62(a)(20).

## Chapter 15

## Gratuitous Transfers

### Page 332

In the fifth line, delete "trust" from "business trust accounting."

### Page 333

In the last line of the second paragraph, the numerical expression should read: $54 (.35 x $154).

**Pages 335-36**

The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 adds new IRC § 1014(f)(1) to the Code. Generally speaking, this new provision states that for income tax purposes, the basis of inherited property cannot exceed its federal estate tax value. This Act also adds to the Code a new IRC § 6035 that directs executors of estates required to file a federal estate tax return to furnish each recipient of a property bequest and the IRS with an information return. The information return must show the estate tax value of the property bequest.

**Page 351**

Rev. Proc. 2013-16, 2013-7 I.R.B. 488, holds that principal reductions in the mortgage on a taxpayer's principal residence pursuant to the federal government's Home Affordable Modification Program are excludable from the taxpayer's gross income under the general welfare exclusion.

**Page 358**

The 2017 TCJA amends IRC § 74(c) to provide that excludable employee achievement awards generally do not include cash, cash equivalents, services, and securities.

## Chapter 16

## CHARITABLE CONTRIBUTIONS

### Page 365

**The 2017 TCJA's restriction on the deduction for state and local taxes has produced state-level action or proposals to circumvent the restriction by giving state income tax credits for contributions made to states or state instrumentalities. The hope is that the contributions will be fully deductible under IRC § 170(a). In response, the IRS has promulgated Prop. Reg. 1.170A-1(h)(3). It provides that (i) if a taxpayer contributes to an IRC § 170(c) entity in consideration for receiving a state or local tax credit, the taxpayer's IRC § 170(a) deduction will be reduced by the amount of the credit, (ii) there will be no diminution in the IRC § 170(c) deduction if the state or local tax benefit is a deduction rather than a credit and the deduction does not exceed the contribution amount, and (iii) there will be no reduction in the IRC § 170 deduction if the state or local tax credit does not exceed 15% of the taxpayer's contribution.**

### Page 367

**The TCJA added new IRC § 512(a)(7) which provides that unrelated business income is increased by a portion of an exempt organization's costs to provide IRC § 132(f) qualified transportation fringes, parking facilities used in connection with IRC § 132(f)(5)(C) qualified parking, or IRC § 132(j)(4)(B) on-premises athletic facilities.**

The 2017 TCJA adds a new IRC § 4968 that imposes a 1.4% excise tax on the net investment income of private colleges and universities that have large endowments.

The 2017 TCJA adds a new IRC § 4960 that generally imposes on tax exempt employers a 21% excise tax on annual compensation payments in excess of $1 Million per year to any highly compensated employee of a tax exempt organization.

### Page 371

The 2017 TCJA effectively removes from the 50% limit cash contributions that would otherwise be subject to that limit and places them under a new, separate 60% limit. This change expires for tax years beginning after 2027.

### Page 373

Regarding Problem 2(b) on Casebook page 373, the 2017 TCJA amends IRC § 170(l) to expressly deny a deduction for Jay's $1,000 "contribution."

## Chapter 17

## Income Shifting Strategies

### Page 387

The IRS has established a practice of allowing employees to effectively transfer the cash equivalent of certain employment benefits to charitable organizations without suffering an income inclusion. For example, in Notice 2014-68, 2014-47 I.R.B. 842, the IRS addressed employer-established programs under which employees elected to give up vacation, sick, or personal leave in exchange for the employer contributing cash to IRC § 170(c) organizations for the benefit of victims of the West African Ebola epidemic. The Notice states that the IRS would not treat such cash payments as gross income or wages of the participating employees if the payments were made before January 1, 2016. Nor would the IRS treat the opportunity to participate in this type of program as causing employees to be in constructive receipt of income. The employees could not claim a charitable contribution deduction with respect to these payments but the respective employers could deduct the payments under IRC § 162 if the requirements of that provision were satisfied. The IRS issued similar guidance in Notice 2016-55, 2016-40 I.R.B. 432, regarding contributions to assist Louisiana storm victims, Notice 2016-69, 2016-51 I.R.B. 832, regarding contributions for the benefit of Hurricane Matthew victims, and Notice 2017-70, 2017-48 I.R.B. __ regarding contributions for the relief of California wildfire victims.

### Page 389

The 2017 TCJA amends the kiddie tax to provide that the net unearned income of a child is taxed at the steeply progressive ordinary income rates applicable to trusts under IRC § 1(e) and at the capital gains rates applicable to individuals and trusts. However, this change expires for tax years beginning after 2025.

### Page 402

The 2017 TCJA modifies the IRC § 1(e) income tax rates applicable to trusts but leaves them steeply progressive in comparison to individual income tax rates.

**Chapter 18**

**Borrowing, Lending, and Interest**

**Page 423**

Effective for tax years beginning after December 31, 2017, the 2017 TCJA adopted a new version of IRC § 163(j) that disallows deductions each year for business interest expense in excess of the sum of (1) a business's business (not investment) interest income, (2) 30% of the business's adjusted taxable income, and (3) the business's floor plan financing interest (i.e. interest earned from financing an auto dealer's acquisition of inventory). Adjusted taxable income is taxable income with certain adjustments that generally increase taxable income but that are beyond the scope of the basic income tax course. Disallowed interest deductions are carried forward indefinitely and treated as business interest expense for purposes of applying § 163(j) in subsequent years. This interest disallowance provision applies regardless of whether the payee is foreign or domestic and regardless of the payor's form of business organization but it does not apply to either a trade or business of performing services as an employee or a business (other than a § 448(a)(3) tax shelter) whose average annual gross receipts for the three years ending with the preceding tax year do not exceed $25 million. **Interest allocable to the business of being an employee is nondeductible personal interest.**

To illustrate, assume that USCo is the wholly owned U.S. subsidiary of ForCo, a foreign corporation, and is subject to new IRC § 163(j). During year 1, the sum of USCo's interest income, 30% of its adjusted taxable income, and its floor plan financing interest is $1,000 and USCo's total business interest expense is $1,500. Only $1,000 is deductible by USCo in Year 1. The remaining $500 is carried forward to Year 2 as business interest deductible in Year 2. Business interest (including the Year 1 carryforward) in excess of the Year 2 IRC § 163(j) limitation is then carried forward as business interest to Year 3, etc., with no limitation on the number of carryforward years.

**Page 426**

The 2017 TCJA generally reduces the $1 million acquisition indebtedness limitation to $750,000 ($375,000 in the case of married taxpayers filing separately) for tax years beginning after 2017 and before 2026. The 2017 TCJA also entirely suspends the deduction for home equity indebtedness with respect to tax years beginning after 2017 and before 2026. **On February 21, 2018, the IRS issued News Release IR-2018-32 which provides the following examples of the operation of IRC § 163(h)(3) during the period affected by the TCJA:**

**Example 1: In January 2018, a taxpayer takes out a $500,000 mortgage to purchase a main home with a fair market value of $800,000. In February 2018, the taxpayer takes out a $250,000 home equity loan to put an addition on the main home. Both loans are secured by the main home and the total does not exceed the cost of the home. Because the total amount of both loans does not exceed $750,000, all of the interest paid on the loans is deductible. However, if the taxpayer used the home equity loan proceeds for personal expenses, such as**

**paying off student loans and credit cards, then the interest on the home equity loan would not be deductible.**

**Example 2: In January 2018, a taxpayer takes out a $500,000 mortgage to purchase a main home. The loan is secured by the main home. In February 2018, the taxpayer takes out a $250,000 loan to purchase a vacation home. The loan is secured by the vacation home. Because the total amount of both mortgages does not exceed $750,000, all of the interest paid on both mortgages is deductible. However, if the taxpayer took out a $250,000 home equity loan on the main home to purchase the vacation home, then the interest on the home equity loan would not be deductible.**

In *Voss v. Comm'r*, 796 F3d 1091 (9th Cir. 2015), the Ninth Circuit reversed the Tax Court and held that individual co-owners of a qualified residence who are not married to each other are each entitled to a separate IRC § 163(h)(3) $100,000 and $1 million limitations, as they then were, with respect to the qualified residence. The IRS has now acquiesced in the Ninth Circuit decision. *See* 2016-31 I.R.B. 193.

## Chapter 19

## Cancellation-of-Debt Income

### Page 436

In the fourth line, substitute "side" for "sits."

### Page 448

The 2017 TCJA expands IRC § 108(f) to include loans discharged because of the student's death or total and permanent disability but the expansion sunsets after 2025. **The 2018 Bipartisan Budget Act extended through the end of 2017 the effectiveness of the IRC § 108(a)(1)(E) exclusion for discharges of qualified principal residence indebtedness. There had been no further extension at the time this update was written.**

## Chapter 20

## Debt and Property

### Page 456

**The 2018 Bipartisan Budget Act extended through the end of 2017 the effectiveness of the IRC § 108(a)(1)(E) exclusion for discharges of qualified principal residence indebtedness. There had been no further extension at the time this update was written.**

### Page 462

In the third paragraph, fourth line, substitute “$10K basis" for "$10 basis."

## Chapter 22

## Realization of Gross Income

### Page 507

The 2017 TCJA limits § 1031 to exchanges of real property not held primarily for sale. **In Rev. Rul. 67-380, 1967-2 C.B. 291 and Rev. Rul. 71-123, 1971-1 C.B. 227, the IRS held that trades of player contracts by professional sports teams were within IRC § 1031. Since such contracts are not real property, the TCJA apparently renders these rulings prospectively inapplicable and requires professional player trades to be treated as taxable events. The resulting valuation issues will be challenging. *See* Valerie Chambers, Brian Elzweig & N. Anna Shaheen, *"There's No Crying in Baseball" or the Taxation Thereof*, 160 TAX NOTES 345 (2018), David van den Berg, *IRS Could Balk at Guidance for Valuing Pro Sports Trades*, 159 TAX NOTES 903 (2018).**

### Page 525

The 2017 TCJA provides that employees who receive certain stock pursuant to the exercise of stock options may elect to defer recognition of gain for up to five years pursuant to complex rules that are outside the scope of the basic income tax course. *See* IRC § 83(i).

## Chapter 23

## Tax Accounting Methods

### Pages 538-39

The 2017 TCJA amends IRC §§ 448 and 471 to provide that if a taxpayer is (1) not a tax shelter and (2) has average annual gross receipts that do not exceed $25 million for the three preceding taxable years, that taxpayer may use the cash method and is excused from using inventory accounting. The $25 million amount is indexed for inflation. In addition, pre-existing exemptions from accrual and inventory accounting continue to be available even if the $25 million gross receipts test is not satisfied, so long as there is clear reflection of income.

### Page 543

It is well established that a cash method taxpayer is not considered to have made an interest payment merely because the interest is added to the debt principal. *See, e.g., Hargreaves* v. *Commissioner*, TC Sum. Op. 2013-37.

### Page 555

The 2017 TCJA adopts a new IRC § 451(b) that provides that the all events test is generally satisfied with respect to income inclusion no later than when income is taken into account by the taxpayer for financial accounting purposes. This new provision strengthens the requirement that the taxpayer's accounting method must clearly reflect income. *See* IRC § 446(b). There are several exceptions to IRC § 451(b) that are outside the scope of the basic income tax course.

### Page 566

The 2017 TCJA adopts a new IRC § 451(c) that codifies Rev. Proc. 2004-34.

### Page 572

The installment method can affect the tax rate because the applicable rate with respect to a particular installment payment is the one that is in effect at the time the payment is received. Thus, 2012 ATRA's increase in the generally applicable long-term capital gain rate from 15% to 20% means that long-term capital gain installment payments received in tax years beginning before January 1, 2013 will generally be taxed at a maximum of 15% while those received in tax years beginning after December 31, 2012 will generally be taxed at up to 20%.

## Chapter 24

## Realization of Loss on the Destruction or Theft of Property

### Pages 583-84

Chief Counsel Memorandum 201529008 (Feb. 4, 2015), held that collision damages to a rental car company's vehicles did not qualify as casualties within the meaning of IRC § 165 "because it is normal and expected that its vehicles will be damaged when it rents such vehicles to numerous customers to be operated over public highways." Because the rental car company did not repair the damage in question, a repair expense deduction was not available.

### Page 586

The 2017 TCJA provides that for losses incurred before 2026 in tax years beginning after 2017, a personal casualty loss is available only if it was attributable to a Presidentially declared disaster. The limitations explained at pages 586-87 of the casebook apply to such losses.

### Page 589

**Rev. Proc. 2018-08, 2018-2 I.R.B. 286, provides safe harbors that can be elected in lieu of value appraisals for purposes of determining the decline in value of damaged property.**

## Chapter 25

## Capital Gains and Losses

### Page 597

The 2017 TCJA essentially retains present-law maximum rates on net capital gains and qualified dividends. Individuals, estates, and trusts have a zero capital gains tax rate for gain that does not exceed the 15% bracket. The 2017 TCJA adopts a new IRC § 1061 which extends the "more than 1 year" holding period requirement of IRC §§ 1222(3), (4) to a "more than 3 year" requirement with respect to the sale or exchange of a partnership interest received as compensation for certain services typically rendered in investment banking activity, hedge fund activity, and private equity fund activity. The provision is complex and outside the scope of the basic income tax course. It was the only, and very limited, reform that the 2017 TCJA made to the so-called carried interest problem of certain compensatory partnership interests qualifying for capital gains treatment (instead of being treated as ordinary compensation income in whole or in part).

### Page 601

The 2017 TCJA amends IRC § 1221(a)(3) to impose non-capital asset treatment on the following items: (1) patents, (2) models or designs whether or not patented, and (3) secret formulas or processes. However, the 2017 TCJA does not repeal IRC § 1235 **which provides that a transfer of all substantial rights to a patent by the holder thereof "shall be considered the sale or exchange of a capital asset held for more than one year." One way of dealing with this conflict is to give full effect to the literal language of IRC § 1235 because its relationship to IRC § 1221(a)(3) mimics the relationship between IRC § 1221(a)(2), which generally provides that business property is not a capital asset, and IRC § 1231(a), which provides that in specified circumstances sales or exchanges of such property will produce long-term capital gains. Nevertheless, the TCJA legislative history clearly states a Congressional intention that as a result of the amendment to IRC § 1221(a)(3), "gains and losses from the sale or exchange of a patent… which is held either by the taxpayer who created the property or a taxpayer with a substituted or transferred basis from the taxpayer who created the property (or for whom the property was created) will not receive capital gain treatment." H.R. Rept. No. 115-466, 115th Cong. 1st Sess. 414 (2017). Moreover, the 2017 TCJA amendment occurred after the enactment of IRC § 1235. Therefore, the amendment can arguably be regarded as implicitly altering IRC § 1235 to conform to the Congressional purpose. It remains to be seen whether Treasury will adopt Regulations consistent with this Congressional purpose or consistent with the literal statutory language.**

In *Long v. Comm'r*, 772 F. 3d 670 (11th Cir. 2014), the taxpayer entered into a contract to acquire real property. The seller unilaterally terminated the contract and the taxpayer sued for specific performance. During the litigation's pendency, which extended for more than one year, the taxpayer sold his interest in the litigation. The Tax Court held that the taxpayer realized ordinary income from the sale because the land would have been IRC § 1221 (a)(1) property in the taxpayer's hands if the contract had been performed. The Eleventh Circuit reversed and held that the thing sold by the taxpayer was his interest in the litigation, which was distinct from the land in question. The court ruled that this litigation interest was not held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business nor was it disqualified from capital asset characterization by the Supreme Court's decision in *Hort v. Comm'r*. Therefore, the taxpayer's sale gain was long-term capital gain. What result under the Eleventh Circuit decision if the terminated contract had been an employment contract and all other facts were unchanged?

**Page 610**

In *Greenteam Materials Recovery PN v. Comm'r,* T.C. Memo 2017-122, the taxpayer sold its contractual rights to provide waste-collection services for certain California municipalities within certain defined areas. The Tax Court held that these contracts were franchises within the meaning of IRC § 1253(b)(1) and that, because the taxpayer retained no post-sale interest of any kind in the contracts, § 1253(a) required that the sales be treated as sales or exchanges for capital gains purposes. Section 1253 does not, however, expressly state that sales or exchanges of franchises automatically produce capital gains and, as explained at casebook page 610, it is settled law that a contract to perform future services is not a capital asset. Thus, the sale thereof yields ordinary income. Nevertheless, in this case, the Tax Court held that because the services contracts were franchises that had been sold without any type of retained interest on the part of the seller, the following language of IRC § 1253(a) implied that the seller's profit was capital gain:

> A transfer of a franchise…shall not be treated as a sale or exchange of a capital asset if the transferor retains any significant power, right, or continuing interest with respect to the subject matter of the franchise….

It seems clearly incorrect to hold that this off-point language means that a sale of a franchise automatically yields capital gain whenever the seller does not retain a prohibited interest in the franchise. The Tax Court cited the Fifth Circuit decision in *McInvale v. Comm'r,* 936 F. 2d 833 (5th Cir. 1991) as adopting this interpretation of IRC § 1253(a) but that appears to stretch *McInvale* beyond its actual holding.

**Page 612**

The PATH Act amended IRC § 1202(a)(4) to provide a 100% exclusion of gain from the sale or exchange of qualified small business stock held for more than 5 years where such stock was acquired after September 27, 2010. This provision also makes the alternative minimum tax inapplicable to such gain.

**Page 615**

**Eratum: in "2. Section 1231," 12th line, delete "do not".**

**Pages 616 and 623**

*See* the update entry for Casebook page 52 regarding the increase in the maximum generally applicable long-term capital gains rate from 15% to 20%. In addition, starting in 2013, higher income taxpayers must pay an additional Medicare tax of 3.8% on net investment income in excess of certain levels. *See* IRC § 1411. Thus, in the generally applicable worst case scenario, long-term capital gains will be taxed at a 23.8% maximum rate.

2012 ATRA made permanent the zero rate for individuals with adjusted net capital gains that would otherwise bear the 10% or 15% ordinary income rate. The 28% maximum rate that applies to collectibles net capital gain and to the non-excluded portion of gain referred to in IRC § 1202(a)(1) and the 25% maximum rate for unrecaptured IRC §1250 gain were all permanent prior to 2012 ATRA and were unaffected by that legislation. 2012 ATRA made permanent the favorable treatment of qualified dividend income in IRC § 1(h)(11).

## Chapter 26

## Recoveries of Expense Items: The Effect of Annual Accounting on Basis and Basis Recovery

### Page 630

The 2017 TCJA (1) limits the NOL deduction to 80% of taxable income (determined without the NOL deduction), (2) generally repeals the two-year carryback, and (3) allows for an indefinite carryforward period. The amount of NOL in excess of the 80% limitation is apparently permanently unavailable.

The 2017 TCJA adopts a new IRC § 461(l) that imposes an overall limitation on the business losses of non-corporate taxpayers for tax years beginning after 2017 and before 2026. The limitation applies to excess business losses which are defined as the excess of the taxpayer's business deductions (including the NOL deduction) over the sum of the taxpayer's aggregate business gross income plus a threshold amount of $250,000 ($500,000 for joint filers), indexed for inflation. Excess business losses are not allowed when they arise and are carried forward and treated as part of the taxpayer's NOL carryforward in subsequent years. They do not, however, change the 80% ceiling on NOL deductions. With respect to partnerships and S corporations, this limitation applies at the partner and shareholder level. The limitation applies after application of the passive loss rules.

The 2017 TA raises the $10 million ceiling on the completed-contract method exception to $15 million.

### Page 635

In *Cosentino v. Comm'r*, T.C. Memo. 2014-186, taxpayers engaged in a tax shelter transaction that they would not have pursued but for the advice of accountants to do so. When the taxpayers were required to pay federal and state income tax deficiencies because the tax shelter was legally ineffective, they received a damages settlement from the accountants. The Tax Court followed *Clark v. Comm'r* and, in simplified terms, excluded the settlement portion that reimbursed the taxpayers for undeducted professional fees, taxes, and penalties that they paid because they entered into a transaction that they would not have engaged in but for the accountants' defective advice. The IRS did not appeal but it issued an Action on Decision stating that it would not follow *Cosentino* because the taxpayers in that case were reimbursed by the accountants for income taxes, interest, and penalties that were lawfully due on a transaction actually entered into. The IRS stated that *Clark* was distinguishable because the taxpayer in that case was reimbursed for additional taxes paid on account of an improvident joint return election made in reliance on a return preparer's bad advice. *See* AOD 2016-01. The IRS did not mention that the damages received in *Cosentino* served to reimburse the taxpayer for an actual and undeducted loss.

A persistent health-threatening natural gas leak from a public utility's storage facility required nearby residents to relocate for 3½ months. The relevant regulator ordered the utility to pay or reimburse the residents for their clean-up and temporary relocation expenses (including hotel costs and pet boarding fees). In Announcement 2016-25, 2016-31 I.R.B. 1, the IRS stated that it "will not assert that an affected area resident must include these payments or reimbursements in gross income." Although no authority is cited, the IRS position is presumably based on the rationale that the residents' relocation costs created basis for them in claims against the utility which, per *Clark*, offset the utility's payments and reimbursements.

## Chapter 28

## Depreciation

### Page 702

The 2017 TCJA expands the availability of expensing under IRC §§ 179 and 168(k). *See* Chapter 6, this update.

### Pages 702-03

*See* the update entries for Casebook page 157 and Casebook page 158.

### Page 705

The 2017 TCJA removes "computer or peripheral equipment" from inclusion in "listed property."

The 2017 TCJA allows IRC § 179 expensing for certain improvements to nonresidential real property. *See* Chapter 6, this update.